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DCI TALKING POINTS

SUBJECT: Declining Soviet Oil Production: Implications and Likely Initiatives

The severity of the slippage in oil production probably caught Gorbachev by surprise. Prior to the recent cut in oil exports, Soviet foreign trade and financial behavior was consistent with a far more optimistic outlook for future hard currency revenues.

- o It may have taken several months for his new oil management team, installed by late March, to understand the depth of the problems facing the industry.

- o It may not have been clear until mid-year that last fall's decline in oil production could not be reversed by the substantial increase in repair brigades sent to the Siberian oilfields.

In his September visit to the Tyumen' fields, the General Secretary took the geologists to task for their exaggeration of exploitable reserves; oil producers were hit for their focus on overproduction of older fields and failure to develop new fields in timely fashion. At the same time, Gorbachev pledged to improve the working conditions in the region and the quality and quantity of oil-production equipment.

- o Gorbachev may be counting on improved worker discipline and management to prop up the production effort while the metal-working and machine-building industries gear up to improve the quality and quantity of needed inputs.

- o As Gorbachev personally noted in his Tyumen' speech, however, the USSR has simply run out of high quality reserves in West Siberia.

Oil production, which reached 12.2 million b/d in 1984, could fall to perhaps 11.3 million b/d in 1986 if measures being discussed are not implemented.

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- A concentrated effort to boost production drilling and reduce the number of inoperable wells could stem the decline--production is now running at about 11.9 million b/d. Such storming would hurt the already neglected exploratory drilling and lead to further harmful overproduction of existing fields.

- For the long term, the Barents Sea offshore area is a big unknown. In our view exploitable oil potential there may in five to ten years provide some relief. The Soviets are beginning to actively explore the area, but so far have found only gas.

In all likelihood the leadership has yet to develop a game plan for coping with the effects of the decline in oil production.

- Cutting back on hard currency exports is manageable for this year. Sustained cutbacks--or, indeed, a decline in the price of oil--will, however, require some hard choices over commensurate cuts in hard currency imports. Gorbachev's pledge to improve consumer welfare makes sharp cuts in grain imports unlikely. Imports of intermediate goods and state-of-the-art equipment and technology are, respectively, critical to mitigating domestic production shortfalls and underwriting a portion of Gorbachev's modernization program. Prospects for boosting export earnings by increasing arms sales to the Middle East are dim, and signs point to increased West European reluctance to boost natural gas imports even if energy demand firms.

- Moscow has yet to give any indication that oil supplies to Eastern Europe would be cut. (A slight disruption in deliveries to Bulgaria this year, apparently was unrelated to the current oil export difficulties.) Gorbachev undoubtedly wishes to avoid the risk of economic instability and attendant political tension resulting from such a move. He is more likely to push the East Europeans even harder to provide quality equipment and technology and to share the costs of joint projects such as new natural gas pipelines.

- The Soviets have been largely unsuccessful in reducing domestic demand for oil despite continued urging from the highest levels. Major cutbacks in domestic oil allocations would be likely to result in disruptive bottlenecks that would threaten Gorbachev's modernization program.

The leadership's strategy for coping with this decline in the short run should become apparent over the next several months as the 1986 plan is unveiled, discussions with East Europeans on oil are surfaced, and contracts are signed (or not signed) with

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Western suppliers. For the longer term, we should get some indication of Soviet intentions from the 12th Five Year Plan later this month or next. One possible option would be the more active solicitation of Western equipment and technology, not necessarily US, including on-site participation and profit sharing, for rapid development in the Barents Sea. While such a proposal would be attractive in terms oil production, it would likely run into substantial resistance from military and naval commands concerned about foreign presence in this sensitive area.

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